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NOTES

MUTUAL FUND ADVISORY FEES AND THE NEW STANDARD OF FIDUCIARY DUTY—INTERPRETING THE 1970 MUTUAL FUND ACT

In its closing days, the Ninety-First Congress legislated a new standard for the courts to apply when called upon to determine the propriety of existing levels of advisory compensation in the mutual fund industry.¹ The Investment Company Amendments Act of 1970² provides that the investment adviser of a fund has a "fiduciary duty" to the fund with regard to the level of management fees it receives. Under the new section 36(b) of the Investment Company Act of 1940,³ either the Securities and Exchange Commission or a shareholder may bring an action in a federal court to enforce this duty.⁴ The extensive

¹ Investment Company Amendments Act of 1970, Pub. L. No. 91-547 (Dec. 14, 1970). The Act became law on December 14, 1970, when it received the President's signature. BNA SEC. REG. & L. REP. No. 81, at A-25 (Dec. 16, 1970).

² S. 2224 was passed by the Senate on May 26, 1969, and was passed by the House on September 23, 1970, with certain amendments. The relevant difference between the bills was that the House version required a plaintiff to establish a breach of fiduciary duty by "clear and convincing evidence." H.R. 17333, 91st Cong., 2d Sess. § 20 (1970). The Senate merely placed an ordinary burden of proof on the plaintiff. S. 2224, 91st Cong., 1st Sess. § 20 (1969). The conferees adopted the Senate version in this regard. H.R. REP. No. 1631, 91st Cong., 2d Sess. 18 (1970). Their conference report was agreed to by the Senate on November 30, 1970, and by the House on December 1. U.S. CODE CONG. & AD. NEWS, No. 14, at 6273 (Dec. 20, 1970).

³ Pub. L. No. 91-547 (Dec. 14, 1970).

⁴ 15 U.S.C. §§ 80a-1 to -52 (1964).

⁴ New § 36(b), amending 15 U.S.C. § 80a-35 (1964), provides:

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission [SEC], or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other ar-

number of shareholder derivative actions instituted under the pre-existing law⁵—a law less favorable to plaintiffs than the new legislation⁶—suggests that concerned shareholders will waste no time instituting actions once the new law takes effect.⁷ Should shareholders fail to proceed, the SEC will undoubtedly use its powers under the Act to institute such actions.

The "fiduciary duty" language of the new law differs from the "reasonableness" standard proposed by the SEC in 1966⁸ and was only proposed after some three years of legislative debate and lengthy SEC-industry negotiations.⁹ Considering the very flexible nature of a "fidu-

rangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

....

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

Pub. L. No. 91-547, § 20 (Dec. 14, 1970).

The somewhat ambiguous language of § 36(b) indicates that not only the investment adviser, but also others who receive compensation from the fund, including fund directors, persons affiliated with the adviser, the fund's principal underwriter, and fund officers, may be attacked under § 36(b) with respect to that compensation.

⁵ Starting in 1959, over 50 suits were instituted under common law principles and the Investment Company Act against mutual fund advisers charging excessive fees. SEC, REPORT ON THE PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 132 (1966) [hereinafter cited as SEC REPORT]; see, e.g., Kurach v. Weissman, 49 F.R.D. 304 (S.D.N.Y. 1970); Horenstein v. Waddel & Reed, Inc., [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,678 (S.D.N.Y. May 26, 1970); Goodman v. Von Der Heyde, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,541 (S.D.N.Y. 1969); Lessac v. Television-Electronics Fund, Inc., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,305 (S.D.N.Y. 1968); Elster v. Dreyfus, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,914 (N.Y. Sup. Ct. 1967).

For a listing of many of these actions, see the chart contained in the 1967 House hearings. *Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 90th Cong., 1st Sess., ser. 90-21, pt. 1, at 277-78 (1967) [hereinafter cited as *1967 House Hearings*].

⁶ See text accompanying notes 109-42 *infra*.

⁷ Section 36(b), as amended, will not take effect until 18 months after enactment. Pub. L. No. 91-547, § 30 (Dec. 14, 1970). The only reason for this delay appears to be to allow advisers time to alter existing management contracts so as to conform to the new fiduciary standard. See H.R. REP. NO. 1382, 91st Cong., 2d Sess. 199 (1970).

⁸ SEC REPORT 143-47.

⁹ See SEC Memorandum of July 9, 1969, to the Comm. on Interstate and Foreign

ciary duty" standard¹⁰ and the differing interpretations already suggested for this term,¹¹ it is by no means clear how the courts will apply this new standard.

I

THE HISTORY OF MUTUAL FUNDS

Prior to the enactment of the Investment Company Act of 1940, open-end investment companies,¹² or mutual funds, were of little consequence in the securities industry, and many of those that did exist suffered from managerial self-dealing. It was not unusual for a manager to sell his own holdings to his fund at a handsome profit or to tap the fund's assets for his personal business ventures. Needless to say, these practices did not encourage investment in the funds.¹³

In 1940 Congress sought to curb these gross abuses by enacting the Investment Company Act,¹⁴ which prohibited most sales and purchases of property between investment companies and their advisers.¹⁵ To protect further the interests of investors, and to add an element of independent decision-making and bargaining power, the Act required that at least forty percent of the fund's board of directors be composed of men "unaffiliated" with the fund's investment adviser.¹⁶ The Act

Commerce of the House of Representatives, *reprinted in Hearings on H.R. 11995, S. 2224, H.R. 13754, H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong., 1st Sess., ser. 91-33, pt. 1, at 138 (1969) [hereinafter cited as 1969 House Hearings]*. This memo reports that the "fiduciary" standard was substituted for the "reasonableness" standard by the Senate Banking Committee after it completed hearings in the spring of 1969. The change was made at the joint recommendation of the SEC and mutual fund industry representatives. *Id.* See notes 76-84 and accompanying text *infra*.

¹⁰ See note 85 *infra*.

¹¹ See note 84 and accompanying text *infra*.

¹² "Open-end" means that the fund continually offers shares for sale and will redeem outstanding shares at their proportionate net asset value. 15 U.S.C. § 80a-5 (1964).

¹³ In 1940, investment companies held assets of approximately \$2.1 billion; of this total, mutual funds accounted for only \$450 million. SEC REPORT 2; see SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES pt. 3, at 22 (1940); Modesitt, *The Mutual Fund—A Corporate Anomaly*, 14 U.C.L.A.L. REV. 1252 (1967); Werner, *Protecting the Mutual Fund Investor: The SEC Reports on the SEC*, 68 COLUM. L. REV. 1, 4 (1968).

For a more detailed discussion of mutual fund growth in the United States, see WHARTON SCHOOL OF FINANCE & COMMERCE, A STUDY OF MUTUAL FUNDS, H.R. REP. NO. 2274, 87th Cong., 2d Sess. 37-44 (1962) [hereinafter cited as WHARTON REPORT].

¹⁴ 1967 House Hearings 27.

¹⁵ 15 U.S.C. § 80a-17 (1964).

¹⁶ *Id.* § 80a-10. Although this is the general rule of the statute, there are exceptions. For example, it does not apply to no-load funds (those which charge investors no commission when they purchase shares). *Id.* § 80a-10(d).

"Affiliated person" is defined in *id.* § 80a-2(a)(3).

also provided that all compensation to be received by the fund's portfolio manager for his investment advice be set forth in a contract that had to receive initial shareholder approval.¹⁷ Every year thereafter, the contract had to be approved by either a majority of the shareholders or a majority of the disinterested directors.¹⁸

That the Act proved almost entirely successful in curbing the most blatant abuses of the industry¹⁹ is evidenced by the confidence it has inspired among small investors. Within the last three decades, the growth in the number of investors owning mutual funds and in the net asset level of all mutual funds has been staggering.²⁰ Yet, along with this phenomenal growth have come problems not clearly foreseen by Congress in 1940.²¹

A. *A Unique Corporate Structure—Advisers Dominate Their Funds*

Many problems, particularly the question of management compensation, can be traced directly to the unique corporate structure of mutual funds, with its built-in conflicts of interest.²² Almost all major

¹⁷ *Id.* § 80a-15(a).

¹⁸ *Id.* § 80a-15(a)(2).

¹⁹ SEC REPORT I.

²⁰ By 1967, the SEC reported that mutual fund assets had grown from \$450 million in 1940 to almost \$45 billion. The number of shareholder accounts had grown from 300,000 to 7.7 million. *Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess., pt. 1, at 125 (1967) [hereinafter cited as *1967 Senate Hearings*]. As of December 31, 1969, the approximate net assets of the 100 largest mutual funds totalled over \$44 billion. MOODY'S BANK & FINANCE MANUAL a53 (1970).

²¹ Congress did, in 1940, anticipate the possibility of growth in the industry and provided for this contingency as follows:

The Commission [SEC] is authorized, at such times as it deems that any substantial further increase in size of investment companies creates any problem involving the protection of investors or the public interest, to make a study and investigation of the effects of size on the investment policy of investment companies and on security markets, on concentration of control of wealth and industry, and on companies in which investment companies are interested, and from time to time to report the results of its studies and investigations and its recommendations to the Congress.

¹⁵ U.S.C. § 80a-14(b) (1964).

Although Congress did provide for such reports, it is unlikely that it foresaw the very massive growth that has in fact taken place and the problems that have accompanied that growth. See *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. 2, at 500 (1940).

²² See Statement of the SEC Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, Oct. 10, 1967, *1967 House Hearings* 26, 33-34; Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 *YALE L.J.* 1258, 1263-65 (1961); Rottenberg, *Developing Limits on Compensation of Mutual Fund Advisers*, 7 *HARV. J. LEGIS.* 309, 312 (1970); Note, *The Mutual Fund and Its Management Company: An Analysis of Business Incest*, 71 *YALE L.J.* 137, 142 n.23 (1961).

The Canadian Committee on Mutual Funds and Investment Contracts, although

mutual funds today are externally managed,²³ which means that the firm or corporation that determines the composition of a mutual fund's investment portfolio is a separate entity from the fund itself. The fund is essentially a pool of capital and the adviser directs that capital into investment opportunities.²⁴

Most of today's major mutual funds were created by their investment advisory firms, or "advisers," which set up the fund, arranged to underwrite the continual sale of its shares to investors, and essentially controlled, from the start, the fund's board of directors.²⁵ Hence, while the fund and its adviser are theoretically two separate entities, with the fund contracting out to the adviser for certain services, it is the adviser that dominates the fund.²⁶

dealing primarily with the problems of Canada's mutual fund industry, gives an excellent analysis of this problem:

In most industrial companies, a considerable portion of the reward to the senior managers is derived from their direct interest in the enterprise. . . . In the mutual fund situation, on the other hand, it is less frequent for managers to look to the success of the mutual fund to generate their compensation. . . . The principal reward of the senior managers is derived from management fees or sales charges, and while these may be affected by the performance of the mutual fund the connection is less direct than is true with an industrial company manager who benefits directly from an increase in the value of his company's shares. This might be expected to increase the susceptibility to conflicts of interest of the mutual fund manager.

REPORT OF THE CANADIAN COMMITTEE ON MUTUAL FUNDS AND INVESTMENT CONTRACTS 274 (1969)..

²³ "This 'externalization of management' is the most striking feature of the industry's organizational pattern." SEC REPORT 45. In explaining this characteristic further, the Report said:

The practice of buying investment advice and management from an external adviser is one of long standing and was firmly imbedded in the industry at the time that the [Investment Company] act was under consideration. The Act permitted it to continue. . . .

. . . [E]xternal management remains predominant even in the case of the largest funds whose resources are clearly large enough to permit them to establish efficient, well-staffed and well-remunerated advisory departments of their own.

Id. at 49-50.

Massachusetts Investors Trust has recently shifted from internal to external management. Compare MOODY'S BANK & FINANCE MANUAL 1151 (1969), with MOODY'S BANK & FINANCE MANUAL 1009 (1970). With net assets of over \$2 billion, Massachusetts Investors Trust is the nation's fourth largest mutual fund (*id.* at a53), and its shift to external management indicates that there has been no lessening of the externalization pattern.

²⁴ *Aldred Inv. Trust v. SEC*, 151 F.2d 254, 260 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946); Note, *The Use of Brokerage Commissions To Promote Mutual Fund Sales: Time To Give Up the "Give-Up,"* 68 COLUM. L. REV. 334 (1968).

²⁵ The investment adviser usually is well represented on the fund's board of directors and maintains effective control over the fund. With respect to the fixing of investment advisory or management fees, this situation creates an obvious conflict of interest between fund managers who control the fund, on the one hand, and the shareholders of the investment company, on the other.

1967 Senate Hearings 10 (statement of SEC Chairman Cohen).

²⁶ At the time of the Wharton study (1958-62), for example, the *Wharton Report*

The Investment Company Act makes this dual corporate structure attractive to investment advisers wishing to set up funds because it enables them to reap large entrepreneurial rewards. Unlike other corporations, an investment company cannot issue stock options to its organizers to enable them to purchase shares at low cost once the fund has appreciated in value. Shares can only be sold at prices proportionate to the net asset level of the fund at any given time.²⁷ On the other hand, this limit does not apply to sales of shares of the investment advisory corporation. As the fund appreciates in value, the management fees increase as well, so that by virtue of its special relationship to the fund the advisory organization becomes a valuable commodity itself. Those with a proprietary interest in the advisory corporation can thereby achieve substantial profits.²⁸

When it comes time for the fund to negotiate with its investment adviser to determine the price it must pay for various portfolio services, it becomes difficult to characterize the resulting rate schedule as an arm's-length transaction. Considering the dominant role the adviser plays in the fund's management,²⁹ it is hard to see how effective bargaining can take place.

Although the Act provides for certain checks on fund management in dealing with the adviser, these safeguards have not been effective in controlling advisory compensation.³⁰ The Act requires initial shareholder approval of an investment advisory contract and reapproval every year thereafter by fund shareholders or a majority of disinterested directors,³¹ but shareholder rejection is highly unlikely.³² Instead, such contracts are often ratified by vast majorities of shareholders.³³ Under these circumstances, advisers have been under little

found that 89% of the funds it studied, or 94.4% of all mutual fund assets, were under the control of advisory groups with no substantial ownership interest in the fund itself. The Wharton group attributed this high incidence of adviser domination to the unusually wide diffusion of ownership of mutual fund shares, the passivity of most fund shareholders, and control of the proxy machinery from the beginning by the adviser that promoted the fund. WHARTON REPORT 64.

²⁷ 15 U.S.C. § 80a-22 (1964). See also Note, *Management Compensation: The SEC Mutual Funds Report*, 3 COLUM. J.L. & SOC. PROBS. 66, 67-68 (1967).

²⁸ See Note, *supra* note 27, at 68. The SEC Report noted that "[t]he securities of about 20 fund advisers are now publicly held." SEC REPORT 46. See generally WHARTON REPORT 452-62.

²⁹ Notes 25-26 and accompanying text *supra*.

³⁰ SEC REPORT 12.

³¹ 15 U.S.C. § 80a-15 (1964).

³² As the SEC points out, shareholders have little choice when voting on advisory contracts. The adviser's dominance and control in running the fund are such that rejection of the contract would leave the fund without management. SEC REPORT 129.

³³ Wymeersch, *Some Aspects of Management Fees of Mutual Funds*, 17 U. BUFFALO L. REV. 747, 753-55 (1968); Note, *supra* note 22, at 148 n.50.

pressure to bargain for their rates,³⁴ while dissatisfied shareholders have taken to the courts to seek redress.

B. *Shareholder Derivative Actions To Lower Advisory Fees—Only Limited Success*

The case of *Saxe v. Brady*³⁵ established a foundation for judicial treatment of shareholder suits alleging excessive management fees under previously existing law. The difficult burdens placed on plaintiffs under the *Saxe* ruling, uniformly adhered to by both state and federal courts,³⁶ provided a major impetus for enactment of the new legislation.³⁷

In *Saxe*, plaintiff shareholders in a mutual fund sought to hold the fund's directors, adviser, and principal underwriter liable for allegedly "wasteful" fees paid to the adviser amounting to one-half percent of net assets, a rate not uncommon in the industry at that time. The advisory contract had been approved and reapproved almost unanimously by the shareholders.³⁸ Finding that the shareholders were properly informed of all material facts on both occasions, the court held that the advisory fee level must be tested by legal standards applicable to shareholder ratification cases:

When the stockholders ratify a transaction, the interested parties are relieved of the burden of proving the fairness of the transaction. The burden then falls on the objecting stockholders to convince the court that *no person of ordinary, sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given.*³⁹

³⁴ The costs of management services to mutual funds are unaffected by the pricing process prevailing in most other areas of the economy outside the public utility field, where prices of goods and charges for services are normally determined "at arm's length and by the forces of competition.

1967 Senate Hearings 10 (statement of SEC Chairman Cohen).

³⁵ 40 Del. Ch. 474, 184 A.2d 602 (Ch. 1962). The case of *Meiselman v. Eberstadt*, 39 Del. Ch. 563, 170 A.2d 720 (Ch. 1961), decided one year before *Saxe*, presaged the *Saxe* holding, but its discussion of the applicable rules was somewhat more limited, and it did not confront a rate as high as the flat 0.5% fee charged in *Saxe*. Hence, *Saxe* is considered the leading case.

³⁶ See *Kurach v. Weissman*, 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970) (indicating that only three major cases—*Saxe*, *Meiselman*, and *Acampora*—have been fully litigated in this area); settlements cited in note 57 *infra* which have all impliedly adopted the *Saxe* rationale; *Acampora v. Birkland*, 220 F. Supp. 527, 549 (D. Colo. 1963). See also 1967 Senate Hearings 21; Wymeersch, *supra* note 33, at 783-87.

³⁷ 1969 House Hearings 188.

³⁸ See notes 17-18 and accompanying text *supra*.

³⁹ 40 Del. Ch. at 486, 184 A.2d at 610 (emphasis added). This statement, together with other statements in *Saxe*, have been variously referred to as the "business judgment," "waste," "shocking," and "unconscionable" standards. *Acampora v. Birkland*, 220 F. Supp. 527, 548 (D. Colo. 1963).

Recognizing that a showing of actual waste of corporate assets would vitiate the effect of shareholder ratification, the court held that plaintiffs must show the fees were so out of proportion to the value of services rendered as to be "unconscionable."⁴⁰

By requiring the application of a waste standard and by placing the burden of proof on plaintiffs to establish the waste, *Saxe* has made recovery in such derivative actions unlikely.⁴¹ So long as the rate structure of the industry and the specific approval of fund shareholders were to be determinative factors⁴² in assessing the existence of legally excessive fees, it is hard to imagine how a plaintiff could prevail.⁴³

Acampora v. Birkland,⁴⁴ decided in a federal court only one year after *Saxe*, adopted the *Saxe* rationale without criticism. Plaintiffs contended that the one-half percent fee was excessive in view of the substantially fewer services offered to the fund by its management adviser than were offered by other advisers to their funds for the same fees. Initially, the court noted that fees paid in excess of the industry average were not necessarily legally excessive under the *Saxe* ruling.⁴⁵ Unable to find that the services rendered were in fact substantially less than those offered by other advisers to their funds, the court held that plaintiffs had not shown the fees charged were "unconscionable" or "shocking" despite the judge's own belief that the rate "seemed high."⁴⁶

⁴⁰ 40 Del. Ch. at 487, 184 A.2d at 610. Among the factors that the court considered important in holding against plaintiffs' complaint were: (1) that the flat 0.5% rate was not uncommon in the industry, and that some funds paid in excess of that rate; and (2) that an overwhelming majority of fund shareholders ratified the advisory contract. *Id.* at 489, 184 A.2d at 611-12.

⁴¹ SEC REPORT 141; *see* Horenstein v. Waddel & Reed, Inc., [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,678 (S.D.N.Y. May 26, 1970) (the likelihood of success in such actions "is not great"); Goodman v. Von Der Heyde, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,541, at 98,493 (S.D.N.Y. 1969) (the likelihood of success in such actions is so poor that the claim might better be addressed to Congress than to the courts).

⁴² *See* note 40 *supra*.

⁴³ In fact, there has never been a successful suit. *Kurach v. Weissman*, 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970). Considering the two factors deemed important by the court in *Saxe* (note 40 *supra*), success is impossible for two reasons: (1) overwhelming shareholder ratification is commonplace in the industry (note 33 and accompanying text *supra*); and (2) the general rate structure of the industry has remained fairly constant over time. As of June 30, 1968, 68 of the 87 funds with net assets over \$100 million had effective management fees of 0.4% or over, 59 with fees of 0.45% or more, and 46 with fees of 0.5% or more. *Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong., 1st Sess. 8-9 (1969) [hereinafter cited as *1969 Senate Hearings*]. Compare these rates with the 0.5% or lower rate referred to in *Saxe* as not uncommon 10 years earlier. 40 Del. Ch. at 489, 184 A.2d at 611.

⁴⁴ 220 F. Supp. 527 (D. Colo. 1963).

⁴⁵ *Id.* at 548.

⁴⁶ *Id.* at 549.

Another approach to shareholder derivative actions alleging excessive fees was suggested by a district court holding in *Brown v. Bullock*⁴⁷ that private rights of action could be implied throughout the Investment Company Act and specifically under section 36.⁴⁸ In affirming the district court,⁴⁹ however, the Second Circuit found private rights of action only in sections 15(a) to (b) and 37,⁵⁰ while it remained silent regarding section 36.⁵¹ It remains highly questionable whether a private right existed, and if so, whether it would have made a significant difference for shareholders bringing derivative actions.⁵² Under the new law, this question has of course become moot.

Saxe has loomed over litigation in this area so as to pose a serious barrier to shareholder challenges of advisory fees.⁵³ The litigation, however, has not been quite as fruitless to shareholders as *Saxe* would indicate. Despite the poor odds for success, many shareholders have

⁴⁷ 194 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961).

⁴⁸ *Id.* at 245-46. See Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 RUTGERS L. REV. 181 (1966); Eisenberg & Phillips, *Mutual Fund Litigation—New Frontiers for the Investment Company Act*, 62 COLUM. L. REV. 73 (1962).

Section 36, 15 U.S.C. § 80a-35 (1964), as it existed prior to December 14, 1970, provided:

The Commission [SEC] is authorized to bring an action in the proper district court of the United States . . . alleging that a person serving or acting in one or more of the following capacities has been guilty . . . of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

- (1) as officer, director, member of an advisory board, investment adviser, or depositor; or
- (2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

⁴⁹ 294 F.2d 415 (2d Cir. 1961).

⁵⁰ *Id.* at 420.

⁵¹ See Werner, *supra* note 13, at 22 n.139.

⁵² It was just this hope—that actions under § 36 would enable federal courts to fashion a federal common law fiduciary duty more favorable to shareholders than the *Saxe* test—that encouraged advocates of an implied right of action. See Eisenberg & Lehr, *supra* note 48, at 224-25. The existence of such a private right of action has been debated. *Taussig v. Wellington Fund, Inc.*, 313 F.2d 472, 476 (3d Cir. 1963). By 1966, the SEC clearly abandoned hope of remedying defects in the Act by judicial construction. SEC REPORT 143. At least one author has concluded that no private right of action could be said to exist under § 36 of the Act. Wymeersch, *supra* note 33, at 787. Recently, *Moses v. Burgin*, 316 F. Supp. 31, 55 (D. Mass. 1970), indicated a judicial reluctance to derive a common law of fiduciary duties under the previously existing § 36 of the Act. *Contra, e.g., Tanzer v. Huffines*, 314 F. Supp. 189, 195 (D. Del. 1970); *SEC v. Quing N. Wong*, 42 F.R.D. 599, 601 (D.P.R. 1967).

⁵³ See note 36 and accompanying text *supra*.

brought actions anyway.⁵⁴ The result has been a number of court-approved settlements providing for various forms of advisory fee reductions.⁵⁵

Most settlements have been modest from the point of view of all parties concerned.⁵⁶ The principal reason the courts have felt compelled to approve these settlements has been the apparent unlikelihood of success by plaintiffs should they proceed to a final judicial determination on the merits.⁵⁷ Advisers have been willing to settle these actions largely because of the dicta of *Saxe* indicating that at some point rates may be held excessive;⁵⁸ in view of the vast sums involved, their willingness is quite understandable.⁵⁹ While settlements and threats of share-

⁵⁴ See note 5 *supra*.

⁵⁵ A listing of these is found in SEC REPORT 154.

⁵⁶ 1967 Senate Hearings 139 (statement of SEC Chairman Cohen):

[T]he median advisory fee paid by the 59 externally managed funds with net assets of \$100 million or more was still 0.48 percent after these settlements. Thus, although some progress has been made in a few individual cases, principally involving the very largest funds, the effect on the overall problem has not been significant.

⁵⁷ *Kurach v. Weissman*, 49 F.R.D. 304, 305-06 (S.D.N.Y. 1970); *Horenstein v. Waddel & Reed, Inc.*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,678 (S.D.N.Y. May 26, 1970); *Goodman v. Von Der Heyde*, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,541 (S.D.N.Y. 1969). *But see* *Norman v. McKee*, 431 F.2d 769 (9th Cir. 1970), where the court of appeals upheld a district court finding that the proposed settlement was "so inadequate and, therefore, so unfair that it should not receive judicial approval." *Id.* at 771.

⁵⁸ In *Saxe*, the court warned that "it is clear both in law and in fact that compensation payments may grow so large that they are unconscionable." 40 Del. Ch. at 487, 184 A.2d at 610. More specifically:

Based on the 1959 and 1960 figures the profits are certainly approaching the point where they are outstripping any reasonable relationship to expenses and effort even in a legal sense. . . . [T]he business community might reasonably expect that at some point those representing the fund would see that the management fee was adjusted to reflect the diminution in the cost factor.

Id. at 498, 184 A.2d at 616-17. *See* *Meiselman v. Eberstadt*, 39 Del. Ch. 563, 567, 170 A.2d 720, 722 (Ch. 1961) ("[r]ecognizing that there must be some limitation on the payment to persons discharging such [advisory] services . . .").

The SEC found *Saxe* was a primary factor in inducing fund managers to agree to settlements. SEC REPORT 138.

⁵⁹ *Kurach v. Weissman*, 49 F.R.D. 304 (S.D.N.Y. 1970), a recent action terminated by a court-approved settlement, is illustrative of the above generalizations. The plaintiff's main complaint was that the management fee paid by Dreyfus Fund to its adviser, the Dreyfus Corporation, was excessive in view of the fund's size. Although Dreyfus is an industry giant, its adviser still charged it a flat fee of 0.5% of net assets with no scale-down, the highest fee of any fund its size. The settlement did not provide for a reduction in the fee rate, but required Dreyfus Corporation to offset against the fee any profits it received from certain fund-related activities. In view of the poor chances for plaintiff's success on the merits, the court felt compelled to approve the settlement even though it found that the maximum guaranteed reduction under the settlement would be from an effective rate of 0.5% to an effective rate of 0.492% of net assets. Similar considerations

holder suits have encouraged a general downward trend with respect to industry fees,⁶⁰ these reductions have not been significant.⁶¹

II

HISTORY OF THE NEW LEGISLATION

A. *The Wharton and SEC Reports—Forerunners of the New Legislation*

In 1962 the Wharton Report⁶² concluded that the fundamental problems in the industry involved the potential conflicts of interest between fund management and fund shareholders, and the possible absence of arm's-length bargaining between funds and their management advisers.⁶³ More specifically, the Report noted that there were distinct economies of scale in managing larger investment portfolios, yet these economies were not being reflected in reduced management fees. This was particularly disturbing, the Report said, in view of significantly lower rates charged by the fund advisers to manage sizeable sums of money for private individuals.⁶⁴

The Wharton Report's conclusions prompted further study by the SEC, which culminated in a Commission report to Congress in 1966.⁶⁵ While noting some recent reductions in advisory fees under the pressures generated by the Wharton Report and pending stockholder litigation, the SEC Report nevertheless found the level of fees highly questionable in view of the costs to advisers in providing portfolio

militated in favor of court approval of minimal settlements in several other cases. *See* Horenstein v. Waddell & Reed, Inc., [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,678 (S.D.N.Y. May 26, 1970); Goodman v. Von Der Heyde, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,541 (S.D.N.Y. 1969); Lessac v. Television-Electronics Fund, Inc., [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,305 (S.D.N.Y. 1968).

⁶⁰ *See* 1969 Senate Hearings 8-9; note 43 *supra*.

⁶¹ In 1967, SEC Chairman Cohen said:

The median advisory fee paid by the 59 externally managed mutual funds with net assets of \$100 million or more in fiscal years ending in 1966 was still 0.48 percent, down only 0.02 percent from the traditional 0.50 percent rate.

1967 Senate Hearings 14. *See* accompanying table, *id.* at 15.

SEC Commissioner Owens made a similar statement to a Senate committee in 1969. 1969 Senate Hearings 8.

⁶² In 1958 the SEC authorized the Securities Research Unit of the Wharton School of Finance and Commerce of the University of Pennsylvania to make a study of the mutual fund industry; in 1962 the report was submitted to Congress. WHARTON REPORT 1.

⁶³ *Id.* at x.

⁶⁴ *Id.* at 28-29.

⁶⁵ SEC REPORT.

management services.⁶⁶ The SEC concluded that new legislation was required to protect investors by ensuring the fairness of advisory compensation.⁶⁷ Specifically, it recommended amendment of the Act to provide expressly that advisory compensation be reasonable,⁶⁸ regardless of shareholder or directorial approval of advisory contracts.⁶⁹ The SEC also recommended that both the Commission and shareholders be given a right of action under the Act to enforce the reasonableness standard.⁷⁰

Going beyond the recommendation of the "reasonableness" test, the SEC offered specific factors for courts to consider in determining reasonableness:⁷¹ (1) the cost of comparable services to other funds; (2) the cost of advisory services to funds that have internalized management;⁷² (3) the cost of services, such as pension and profit-sharing plans, to non-fund clients of advisers;⁷³ (4) the nature and extent of services provided; (5) the past performance of the fund and how beneficial past services to the fund have been; and (6) other compensation the adviser may receive from its relation to the fund.⁷⁴ The Commission was particularly anxious to make clear that director or shareholder approval should not affect the application of this reasonableness standard. Specifically, it did not want such approval to result in the application of judicial tests associated with shareholder ratification cases.⁷⁵

⁶⁶ *Id.* at 95-125.

In summary, the SEC Report found that management fees did not reflect the substantial economies of scale inherent in portfolio management; that advisers charged funds substantially higher prices for investment services than other financial institutions charged their clients; and that the then-existing limits on advisory compensation had proven inadequate. *Id.* at 10-13.

⁶⁷ *Id.* at 143-47.

⁶⁸ *Id.* at 144.

⁶⁹ *Id.*

⁷⁰ *Id.* at 146.

⁷¹ *Id.* at 144-45.

⁷² The Wharton study found that the cost to internally managed funds of maintaining advisory apparatus was substantially smaller than the fees paid by externally managed funds to their advisers. WHARTON REPORT 485.

⁷³ The Wharton study was particularly disturbed by the disparity between the fees advisers charged to their other, non-fund, clients and the fees they charged the funds: [The] evidence suggests that the lower rates charged other clients have little to do with difference in expenses, which on a priori grounds would seem to favor relatively low and significantly declining rates for open-end companies with increases in asset size.

Id. at 493.

⁷⁴ This would include profits derived by advisers that maintain subsidiaries to handle underwriting of fund shares and fund-related brokerage transactions. *See generally id.* at 471-75, which details relationships existing among advisers, underwriters, and brokers.

⁷⁵ SEC REPORT 145-46. The *Saxe* holding provided that the applicable standards were those of shareholder ratification cases. Hence it applied a "waste," or "business judgment" test to the fee structure. *See* notes 39-40 and accompanying text *supra*. The

B. *Legislative Debate and Action*

The standard of "reasonableness" recommended by the SEC was initially incorporated in bills submitted in the House and Senate in 1967.⁷⁶ The industry, however, was vehemently opposed to the legislation's "reasonableness" test⁷⁷ and succeeded in blocking passage of the bill at that time.⁷⁸ Nevertheless, the bill was introduced again in 1969;⁷⁹ the Senate Banking Committee again held hearings and elicited much the same polarized response to the reasonableness standard.⁸⁰

While these hearings were in progress, negotiations on the substance of the bill continued between the industry and the SEC. Perhaps aware of the increasing likelihood that some legislation would be adopted, the Investment Company Institute began to concentrate its criticism on the details of the bill itself.⁸¹ In May 1969, the SEC and industry representatives reached a compromise and submitted their proposal to the House committee.⁸² In place of the standard of reasonableness, both parties agreed that the adviser should have a fiduciary duty to its fund with regard to the level of compensation the adviser

SEC, in proposing its reasonableness test, wanted to make clear that "reasonable" would not be converted to "waste" by the operation of shareholder ratification. SEC REPORT 145-46.

⁷⁶ H.R. 9510, 90th Cong., 1st Sess. § 8(d) (1967); S. 1659, 90th Cong., 1st Sess. § 8(d) (1967).

In describing the proposed standard, Manuel Cohen, the SEC Chairman at that time, said: "We ask only that by specific language in the act Congress make explicit the authority of the courts to determine as a matter of Federal law whether, in a particular situation, the fund's advisory fee is reasonable." *1967 Senate Hearings* 22. In specifying the factors relevant to a determination of reasonableness, Chairman Cohen said:

The specific factors listed are the extent to which the fees reflect a sharing of the economies of size, the nature, extent and quality of the services provided—and I emphasize the quality—and the value of all other benefits received.

.....
The investment adviser and the directors of the investment company [would] have a fiduciary responsibility to that corporation and all of its shareholders to assure that the company is not subject to an unreasonable fee.

Id. at 22-23.

⁷⁷ The industry contended fees were already reasonable, the legislation would merely encourage "strike" suits, and the SEC would in effect be given the power to regulate a competitive industry. *1967 Senate Hearings* 191-92, 201. Members of the industry rejected all the relevant conclusions of the Wharton and SEC Reports, maintaining that their industry was truly competitive vis-à-vis management fees, that there was in fact real arm's-length bargaining for the fees between unaffiliated directors and advisers, and that fees had significantly dropped in recent years. *Id.* at 193, 197.

⁷⁸ A similar bill passed the Senate in 1968 but died in the House. See Rottenberg, *supra* note 22, at 333-37.

⁷⁹ S. 34, 91st Cong., 1st Sess. (1969).

⁸⁰ *1969 Senate Hearings*.

⁸¹ See, e.g., *id.* at 88-92.

⁸² *1969 House Hearings* 138.

receives.⁸³ They did not agree, however, on the definition of fiduciary duty.⁸⁴

III

THE FIDUCIARY STANDARD

To say that a fiduciary relationship exists between the adviser and its mutual fund does not establish a clear-cut answer to litigation; rather, it merely opens the door to broad judicial inquiry.⁸⁵ There are numerous relationships that have been characterized as fiduciary in nature to which the duties of an adviser under the new legislation might be analogized. Among the most widely recognized fiduciary relationships are those between a trustee and his *cestui*, between an attorney and his client, and between a director and his corporation.⁸⁶

The standards applicable to each of these fiduciary relationships may differ.⁸⁷ For example, the duties of a corporate director may vary

⁸³ S. 2224, 91st Cong., 1st Sess. § 20 (1969).

⁸⁴ Of particular relevance to any discussion of fiduciary duty in the advisory fee context is the different characterization of the compromise offered by both parties to the discussions. An SEC memorandum to the House Committee on Interstate and Foreign Commerce said:

The Commission views this [standard] as a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard of S. 34.

The Commission therefore supports these provisions as a satisfactory and even more effective method than its original proposal to test the reasonableness of mutual fund management fees.

1969 House Hearings 138-39 (emphasis added). In contrast to the SEC's characterization of the compromise, Senator Brooke, who is somewhat less critical of the industry, remarked:

This, in my judgment, represents a significant improvement over last year's bill in that *unconscionable management fee contracts can be challenged*; however, the judiciary does not assume the role of a "rate fixer" [as it would under the reasonableness standard].

115 CONG. REC. 13,699 (1969) (emphasis added).

⁸⁵ In his often-quoted opinion in *SEC v. Chenery Corp.*, 318 U.S. 80 (1943), Justice Frankfurter said:

[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respects has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

Id. at 85-86.

⁸⁶ *In re Consolidated Rock Prods. Co.*, 36 F. Supp. 912, 914 (S.D. Cal. 1941) (debtor who held property as trustee for his creditors thereby occupied a fiduciary relationship to them); *Finn v. Monk*, 403 Ill. 167, 181, 85 N.E.2d 701, 708 (1949); *Hun v. Cary*, 82 N.Y. 65 (1880); cases cited in note 96 *infra*. See also H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* § 235 (2d ed. 1970); Wymeersch, *supra* note 33, at 756.

⁸⁷ "Some fiduciary relationships are undoubtedly more intense [*i.e.*, involve more

significantly from those of a trustee.⁸⁸ Corporate directors require more freedom of action and must, on occasion, be permitted to have dealings with their corporations. The concept of fiduciary obligation, however, tends to uphold such transactions only after rigorous judicial scrutiny.⁸⁹

A. *The Adviser's Fiduciary Obligation as Analogous to Fiduciary Obligations in the Corporate Context*

For a variety of reasons, the investment adviser's obligations seem most closely allied to the fiduciary obligations of corporate directors. Most obviously, the adviser itself is often the dominant influence upon the fund's board of directors and occupies several of its seats.⁹⁰ In this sense, the adviser owes duties to the corporation and its shareholders similar to those owed by any director.⁹¹ Secondly, if the adviser is

rigorous standards of conduct] than others." Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539, 541 (1949). One authority on corporations has stated:

While analogies to fiduciary principles applied to trustees, partners, joint venturers, agents, and others in fiduciary positions may be helpful, such principles are not always strictly applicable to the director, officer, and controlling shareholder [of a corporation].

H. HENN, *supra* note 86, § 235, at 458. See H. BALLANTINE, BALLANTINE ON CORPORATIONS § 66 (rev. ed. 1946); H. HENN, *supra* note 86, § 235, at 458 n.3.

⁸⁸ [D]irectors occupy a fiduciary relation to the corporation, and to its creditors and stockholders. This relation is analogous to that of agent to principal, and trustee to cestui que trust, but it is not of so intimate and confidential a character as either of these.

Wyman v. Bowman, 127 F. 257, 273 (8th Cir. 1904). See note 87 *supra*.

⁸⁹ See York v. Guaranty Trust Co., 143 F.2d 503, 514 (2d Cir. 1944), *rev'd on other grounds*, 326 U.S. 99 (1945) (courts should not impose impractical obligations on fiduciaries); H. HENN, *supra* note 86, § 235, at 458 (directors are not subject to the strictest rules applicable to fiduciaries such as trustees, given the different business context and the necessities of corporate operation); note 97 *infra*. See also Wyman v. Bowman, 127 F. 257, 273 (8th Cir. 1904), for a lengthy discussion of the reasons why corporate fiduciaries are not subject to as strict standards as other kinds of fiduciaries; H. BALLANTINE, *supra* note 87, at § 72; Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335, 335-36 (1948).

⁹⁰ See notes 25-26 *supra*.

⁹¹ Since the enactment of the Investment Company Act, the adviser in this sense has been held to occupy a fiduciary relationship to the fund. SEC v. Insurance Sec., Inc., 254 F.2d 642, 650 (9th Cir.), *cert. denied*, 358 U.S. 823 (1958); Aldred Inv. Trust v. SEC, 151 F.2d 254, 260 (1st Cir. 1945), *cert. denied*, 326 U.S. 795 (1946). It is important to note that the problem confronted by shareholders under the old law was not the total absence of fiduciary duties, but the *Saxe* decision to treat litigation in this area as involving ratification, which called for the application of a very loose "waste" standard. See notes 39, 41, 43 and accompanying text *supra*.

With respect to the duties of a director generally, see H. HENN, *supra* note 86, at §§ 235-42.

Regarding this characterization of the adviser as a director of the mutual fund because some of the persons who control the adviser sit on the board of directors of the mutual fund, consider *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969),

viewed as a director, the advisory contract may be viewed both as a contract between a corporation and one of its directors and as a contract between two corporations with common directors (since the "adviser" sits on the advisory firm's board of directors as well as the fund's board). Moreover, the advisory contract may be viewed as a form of management compensation, thus bringing to bear principles that are applicable when directors and officers of a corporation fix their own compensation.⁹² Although the anomalous structure of the mutual fund⁹³ requires that these characterizations be qualified,⁹⁴ the concept of the corporate fiduciary does serve to indicate the applicable fiduciary standards.

B. *The Meaning of Fiduciary Duties in the Corporate Context*

Under normal circumstances, when directors act within their authority, in good faith, and without any conflicts of interest, courts will not overturn challenged directorial actions unless the actions can be shown to amount to a waste of corporate assets.⁹⁵ In considering transactions in which corporate fiduciaries have conflicts of interest, however, the modern view has been to uphold such transactions only if they are determined to be fair.⁹⁶ In determining the fairness of such transac-

cert. denied, 396 U.S. 1036 (1970). There, the Second Circuit held that for purposes of liability under § 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b) (1964), Martin Marietta Corporation was a "director" of Sperry Rand Corporation because Martin's president and chief executive sat as Martin's representative on Sperry's board of directors.

⁹² See H. HENN, *supra* note 86, at §§ 243-44.

⁹³ See notes 22-34 and accompanying text *supra*.

⁹⁴ The mutual fund is a corporation in which those with no ownership whatsoever control the operation of the organization. The fund cannot be viewed as a subsidiary to the adviser because the adviser has no proprietary interest in the fund. The mutual fund is a corporation whose shareholders have chosen to submit to the domination of another business entity—the adviser. See, e.g., the discussion of whether the fund is really a separate entity at all or merely a vehicle whereby money is managed for a fee, in REPORT OF THE CANADIAN COMMITTEE ON MUTUAL FUND AND INVESTMENT CONTRACTS 104-05 (1969).

⁹⁵ *McQuillen v. National Cash Register Co.*, 112 F.2d 877, 884 (4th Cir.), *cert. denied*, 311 U.S. 695 (1940); *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968); *Nahikian v. Mattingly*, 265 Mich. 128, 251 N.W. 421 (1933); *Seitz v. Union Brass & Metal Mfg. Co.*, 152 Minn. 460, 189 N.W. 586 (1922); see H. HENN, *supra* note 86, § 242, at 482 n.4.

⁹⁶ *Pepper v. Litton*, 308 U.S. 295 (1939); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Corsicana Nat'l Bank v. Johnson*, 251 U.S. 68 (1919); *Murphy v. Washington Am. League Base Ball Club, Inc.*, 324 F.2d 394 (D.C. Cir. 1963); *Irving Bank-Columbia Trust Co. v. Stoddard*, 292 F. 815 (1st Cir. 1923); *Ransome Concrete Mach. Co. v. Moody*, 282 F. 29 (2d Cir. 1922); *Wyman v. Bowman*, 127 F. 257 (8th Cir. 1904); *Colorado Management Corp. v. American Founders Life Ins. Co.*, 145 Colo. 413, 359 P.2d 665 (1961); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 121 N.E. 378 (1918); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App. 1962); see H. BALLANTINE, *supra* note 87, at §§ 67-68; H. HENN, *supra* note 86, at § 238.

tions, courts apply the most rigid judicial scrutiny.⁹⁷ This is true whether the conflict involves a director sitting on the boards of corporations that have dealings with each other or a director having dealings with his own corporation.⁹⁸ It is also true when the conflict involves directors fixing their own compensation.⁹⁹

In determining the fairness of a transaction, the Supreme Court has stated that "[t]he essence of the test is whether or not *under all the circumstances* the transaction carries the earmarks of an arm's length bargain."¹⁰⁰ If the court does not find the transaction "inherently fair,"¹⁰¹ it may set aside the transaction.¹⁰² There must be a "reasonable proportion between benefits and burdens";¹⁰³ the corporation must receive full value for its expense;¹⁰⁴ and courts have found it important to determine whether there was full disclosure and whether the transaction was at, below, or above market price.¹⁰⁵

Since fairness is, of necessity, a difficult term to define precisely, and, a fortiori, to prove, litigation in this areas has been as concerned with determining which party has the burden of proof as with defining fairness. It has generally been held that where the fairness of transactions involving conflicts of interest is questioned, the burden is upon the defendant directors to show fairness.¹⁰⁶

⁹⁷ *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921); *Meinhard v. Salmon*, 249 N.Y. 458, 463, 164 N.E. 545, 546 (1928).

⁹⁸ *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 282, 166 N.E.2d 793, 801 (1960). H. HENN, *supra* note 86, § 238, at 465 & n.1, indicates the rules may be slightly stricter for transactions between a corporation and one of its directors than between two corporations with common directors.

⁹⁹ *Backus v. Finkelstein*, 23 F.2d 357 (D. Minn. 1927); *Ransome Concrete Mach. Co. v. Moody*, 282 F. 29 (2d Cir. 1922).

¹⁰⁰ *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939) (emphasis added).

¹⁰¹ *Id.* at 306.

¹⁰² See *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 588 (1875) (stating that a contract negotiated by directors with conflicting loyalties may be set aside "on slight grounds"); H. HENN, *supra* note 86, at § 238.

¹⁰³ *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 490, 121 N.E. 378, 380 (1918).

¹⁰⁴ *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921).

¹⁰⁵ *Shlensky v. South Parkway Bldg. Corp.*, 19 Ill. 2d 268, 283, 166 N.E.2d 793, 801-02 (1960).

¹⁰⁶ *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (contract between a director and his corporation); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) (contract between two corporations with common directors); *Wyman v. Bowman*, 127 F. 257 (8th Cir. 1904); *Backus v. Finkelstein*, 23 F.2d 531 (D. Minn. 1924); *Baker v. Hellner Realty Co.*, 265 Mich. 625, 251 N.W. 793 (1933); *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 121 N.E. 378 (1918). *But see Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 412, 8 N.E.2d 895, 905 (1937). See also H. BALLANTINE, *supra* note 87, at § 70; H. HENN, *supra* note 86, at § 238.

Under certain circumstances, however, this burden may be altered or may shift back to the plaintiff. For example, it has been held that majority shareholder approval, or ratification, of directorial actions will place the burden on the plaintiff to prove the unfairness of the transaction.¹⁰⁷ But for ratification to have this effect, it must be meaningful ratification, made with full knowledge of all circumstances.¹⁰⁸

C. *Application of Directorial Fiduciary Standards to Mutual Fund Advisers—Burden of Proof and Determinants of Fairness*

It is clear that the mutual fund cases will no longer be treated as ratification cases, but rather as fiduciary duty cases in which the adviser-director has conflicts of interest.¹⁰⁹ As such, they would normally be treated as situations where the adviser-defendant has the burden of proving the fairness of the transaction under common law principles.¹¹⁰ Section 36(b)(1) appears, however, to deviate from the corporate director cases by placing on the plaintiff the burden of proving a breach of fiduciary duty.¹¹¹ Arguably, this standard requires the plaintiff to dem-

¹⁰⁷ *Corsicana Nat'l Bank v. Johnson*, 251 U.S. 68 (1919); *Olson Bros. v. Englehart*, 42 Del. Ch. 348, 211 A.2d 610 (Ch. 1965); *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (Ch. 1962) (this, of course, was the case in which shareholder ratification of mutual fund advisory fees was deemed to shift the burden to the plaintiff and require him to establish "waste"; see text accompanying note 39 *supra*); *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 91 A.2d 57 (Ch. 1952); *United States Steel Corp. v. Hodge*, 64 N.J. Eq. 807, 54 A. 1 (Ct. Err. & App. 1903); see H. HENN, *supra* note 86, at § 194.

¹⁰⁸ *United Hotels Co. of America v. Mealey*, 147 F.2d 816, 819 (2d Cir. 1945); *First Trust & Sav. Bank v. Iowa-Wisconsin Bridge Co.*, 98 F.2d 416, 427 (8th Cir. 1938); *Cahall v. Lofland*, 12 Del. Ch. 299, 319, 114 A. 224, 234 (Ch. 1921); *Berendt v. Bethlehem Steel Corp.*, 108 N.J. Eq. 148, 151-52, 154 A. 321, 322-23 (Ch. 1931) (court agreed to issue injunction against directors seeking to obtain shareholder ratification of actions then under challenge in the courts); see H. BALLANTINE, *supra* note 87, at § 71.

¹⁰⁹ New § 36(b)(2) as set forth in note 4 *supra*; see 1969 *House Hearings* 177, 188.

It should be noted at this point that the *Saxe* court did not have to treat that litigation as a case of shareholder ratification. *Pappas v. Moss*, 393 F.2d 865, 868 (3d Cir. 1968), held that where those interested in a transaction control a majority of shares, there can be no shareholder ratification, at least to the extent that it shifts the burden of proof to the party attacking the transaction. *Globe Woolen Co. v. Utica Gas & Elec. Co.*, 224 N.Y. 483, 491-92, 121 N.E. 378, 380-81 (1918), held that a dominant corporate officer with conflicting interests could not abstain from voting and then set up ratification by his board of directors as a defense to unfairness; the court said his refusal to vote does not "nullify . . . an influence and predominance exerted without a vote." See also *Wymeersch*, *supra* note 33, at 786; note 108 and accompanying text *supra*. Thus, rather than finding shareholder approval controlling, *Saxe* could have found the ratification meaningless in view of the adviser's control of the proxy mechanism and the history of a high incidence of shareholder ratification in the industry. *United Hotels Co. of America v. Mealey*, 147 F.2d 816, 819 (2d Cir. 1945).

¹¹⁰ See note 106 and accompanying text *supra*.

¹¹¹ See note 4 *supra*.

onstrate that the transaction is unfair by a clear preponderance of the evidence,¹¹² but this view need not be accepted without qualification. By applying traditional principles of statutory construction, the significance of the deviation can be clarified.

Where a statute alters rights and burdens recognized by the common law, it is generally given a strict interpretation to avoid the change asserted;¹¹³ yet, remedial statutes are also liberally construed to carry out the purposes for which they were enacted.¹¹⁴ It can be argued on two grounds that the plaintiff should not have the full burden of proof. First, the common law would place the burden on the defendant to prove fairness, and the statute's terse language does not make clear that it intends to completely shift the burden.¹¹⁵ Second, the purpose of the statute is to allow shareholders to obtain full judicial inquiry into advisory fees. Placing a full burden of proof on plaintiffs might well result in a continuation of present shareholder difficulties in the courts.¹¹⁶

A helpful approach to this dilemma has been offered by courts in several jurisdictions.¹¹⁷ They suggest that when shareholders challenge an action by a corporate fiduciary in which that fiduciary has conflicts of interest, the shareholder must bring forward some evidence that unfairness or irregularity was involved in the transaction; once the shareholder has thereby established a prima facie case, the burden of explanation shifts to the director to justify the fairness of the transaction.

In *Mayflower Hotel Stockholders Protective Committee v. Mayflower Hotel Corp.*,¹¹⁸ minority shareholders alleged that a majority shareholder had used his controlling position to depress the price of Mayflower Hotel Corporation stock so that he could purchase additional shares at bargain prices. According to the complaint, the majority shareholder then sold out his interest to Hilton Hotels Corporation,

112 SEC Commissioner Owens stated that the shareholder "must prove [a breach of fiduciary duty] by a preponderance of the evidence as in any other lawsuit." 1969 Senate Hearings 20.

113 3 J. SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 6201 (3d ed. 1943).

114 *Id.* § 5701.

115 Indeed, the House language requiring plaintiff to prove a breach of fiduciary duty by "clear and convincing evidence," which might have eliminated any ambiguity in the Act, was deleted in conference committee. See note 1 *supra*.

116 See note 41 and accompanying text *supra*.

117 *Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp.*, 73 F. Supp. 721 (D.D.C. 1947), *rev'd*, 173 F.2d 416 (D.C. Cir. 1949); *Hackley v. Oltz*, 105 So. 2d 20 (Fla. Dist. Ct. App. 1958); *Sage v. Culver*, 147 N.Y. 241, 41 N.E. 513 (1895); *Baker v. Cohn*, 42 N.Y.S.2d 159 (Sup. Ct. 1942), *modified & aff'd*, 266 App. Div. 715, 40 N.Y.S.2d 623 (1st Dep't 1943), *aff'd mem.*, 292 N.Y. 570, 54 N.E.2d 689 (1944).

118 73 F. Supp. 721 (D.D.C. 1947), *rev'd*, 173 F.2d 416 (D.C. Cir. 1949).

which used its dominant position to negotiate a favorable management contract with Mayflower. In discussing plaintiff's burden in such cases, the court stated that where an interlocking structure is shown to exist, the plaintiff need show little else to make out a prima facie case and shift the burden of proof.¹¹⁹

In *Baker v. Cohn*,¹²⁰ plaintiff owned forty percent of the stock of a corporation. His relationship to the business became largely passive, while defendants, majority stockholders, were directly involved in operating the business. Evidence showed that defendants withdrew forty-four percent of gross income during the years 1935-40 as salaries and commissions, and that the ratio of salaries to net income during those years ranged from eighty percent in 1937 to 102 percent in 1935. The court held that this showing of unreasonable salaries was sufficient to cast upon the defendants the burden of offering an explanation.¹²¹

Baker was relied upon most recently in *Hackley v. Oltz*,¹²² a case with very similar facts. Plaintiffs in *Hackley*, forty percent stockholders, alleged that the remaining three majority stockholders, who were also the directors of the corporation, had authorized payment to themselves of excessive bonuses and salaries from the corporation in complete disregard of actual services rendered. This allegation was based upon the undisputed fact that bonuses were to be based on a percentage figure making no reference to the specific services defendants had rendered. In reversing a lower court dismissal of the action, the court stated:

It was alleged that the payments by the directors to themselves were excessive and unwarranted by the services rendered. . . . A review of the evidence convinces us that the plaintiffs presented

¹¹⁹ *Id.* at 724.

The district court then went on to hold that the prima facie case to be alleged must demonstrate a grossly inequitable or fraudulent transaction, not one that is merely unfair. Finding that the allegations were only of unfairness and of errors of judgment, the court dismissed the complaint. Its decision on this point was reversed by the District of Columbia Circuit, 173 F.2d 416 (D.C. Cir. 1949), which held that all the shareholder must challenge is the fairness and adequacy of consideration involved in the transaction.

¹²⁰ 42 N.Y.S.2d 159 (Sup. Ct. 1942), *modified & aff'd*, 266 App. Div. 715, 40 N.Y.S.2d 623 (1st Dep't 1943), *aff'd mem.*, 292 N.Y. 570, 54 N.E.2d 689 (1944).

¹²¹ *Id.* at 166.

As support for its holding, the court cited *Sage v. Culver*, 147 N.Y. 241, 41 N.E. 513 (1895). In *Sage* the court stated:

When it can fairly be gathered from all the allegations of a complaint that the officers and directors of a corporation have made use of relations of trust and confidence in order to secure or promote some selfish interest, enough is then averred to set a court of equity in motion and to require an answer from the defendants in regard to the facts.

Id. at 247, 41 N.E. at 514.

¹²² 105 So. 2d 20 (Fla. Dist. Ct. App. 1958).

sufficient evidence to establish a prima facie case. At this point the burden of going forward with the evidence shifted to the defendants.¹²³

Given, then, the conflicting interests of the mutual fund adviser¹²⁴ and its dominance of the fund's board of directors,¹²⁵ it can be argued that this kind of prima facie rule should apply. The showing of certain facts indicating possible unfairness to the fund¹²⁶ should be sufficient to shift the burden of explanation to the defendant-adviser, notwithstanding section 36(b)(1) of the amended Act. Section 36(b)(1) merely places the burden of proof on the plaintiff; if the defendant sufficiently justifies his actions when confronted by the prima facie case so as to meet his burden of coming forward with evidence, the burden of persuasion may, then, still be said to rest with the plaintiff, thereby following the statutory language.

It can also be argued, however, that once the plaintiff has established his prima facie case of unfairness, the burden should shift permanently to the defendant to establish the fairness of the advisory contract by a preponderance of the evidence. This would not only serve to effectuate the remedial purposes of the statute, but it would also be the rule that least departs from the common law of fiduciary duties of directors. Courts have been strict in considering transactions in which corporate fiduciaries have conflicting interests, and have generally placed a heavy burden of proof on the defendants.¹²⁷ Such an interpretation of section 36(b)(1)—requiring the plaintiff to establish a prima facie case and then shifting the burdens of producing evidence and of persuasion permanently to the defendant—is not ruled out by the legislative history of the Act.¹²⁸

Regardless of the burdens of production and persuasion in these cases, it is necessary to consider what factors courts may deem relevant to a determination of fairness under the new legislation. The statute itself gives little guidance, except for indicating that the court may view

¹²³ *Id.* at 23-24 (citing *Baker*).

¹²⁴ See note 22 and accompanying text *supra*.

¹²⁵ See note 25 and accompanying text *supra*.

¹²⁶ These facts are discussed in notes 136-41 and accompanying text *infra*.

¹²⁷ See notes 97 & 106 and accompanying text *supra*.

¹²⁸ The reason for the legislation was the inability of shareholders to obtain judicial relief from present levels of management fees. SEC REPORT 143; H.R. REP. No. 1382, 91st Cong., 2d Sess. 7 (1970); S. REP. No. 184, 91st Cong., 1st Sess. 5 (1969). The major difficulty under prior law was the heavy burden of proof placed upon the plaintiff. See notes 41-43 and accompanying text *supra*. By adopting a prima facie rule that shifts both the burdens of production and persuasion to the defendant, the courts will be furthering the remedial purposes of the statute. See text accompanying note 114 *supra*.

disinterested director or shareholder approval of advisory fees as it deems "appropriate under the circumstances."¹²⁹ There can be little doubt that shareholder ratification will not be the controlling factor it was under the *Saxe* doctrine.¹³⁰ Considering that mutual fund shareholders almost always ratify advisory contracts by vast majorities¹³¹ and that the adviser controls the proxy machinery,¹³² it is unlikely that courts will give much weight to ratification as a determinant of fairness.¹³³

Looking, then, to generally accepted tests of fairness, it can be said that the transaction must be "inherently fair," the fund must receive full value for its expenses, and the transaction must carry the "earmarks" of an arm's-length bargain.¹³⁴ The court will look to all the circumstances of the transaction to determine fairness.¹³⁵ Beyond this, however, there is little direct guidance as to what specific factors should be relevant to a determination of fairness. Thus, the new law's legislative history as well as the SEC statement should be consulted for guidance as to possibly relevant determinants of fairness.

In its report, the Senate Banking Committee stated that "the best industry practice will provide a guide" to the legality of challenged advisory fees—*i.e.*, if one adviser charges a higher fee than another under comparable conditions of size and costs, the fee becomes questionable.¹³⁶ The Committee also indicated that fees should reflect an effort by advisers to share economies of scale in mutual fund management with shareholders.¹³⁷

¹²⁹ See § 36(b)(2), in note 4 *supra*.

¹³⁰ S. REP. NO. 184, 91st Cong., 1st Sess. 15-16 (1969), states that ratification is not to be controlling, but is merely one factor to be considered in determining fairness. See 1969 *House Hearings* 188; note 109 *supra*.

¹³¹ Text accompanying note 33 *supra*.

¹³² See note 26 and accompanying text *supra*.

¹³³ Courts have generally refused to give effect to ratification when it is a mere formality. *Pappas v. Moss*, 393 F.2d 865 (3d Cir. 1968); *Abelow v. Symonds*, 40 Del. Ch. 462, 184 A.2d 173 (Ch. 1962); *Schiff v. RKO Pictures Corp.*, 34 Del. Ch. 329, 104 A.2d 267 (Ch. 1954); see note 108 and accompanying text *supra*.

¹³⁴ See text accompanying notes 100-01, 104 *supra*.

¹³⁵ *Pepper v. Litton*, 308 U.S. 295, 306 (1939).

¹³⁶ S. REP. NO. 184, 91st Cong., 1st Sess. 6 (1969).

¹³⁷ *Id.* The Committee was apparently motivated by the Wharton and SEC Reports' findings of substantial economies of scale in portfolio management as funds increase in size. See notes 64, 66 and accompanying text *supra*. Some funds have instituted scale-downs whereby the percentage fee decreases gradually as fund assets increase. See SEC REPORT 138 n.169. Apparently, this would constitute the "best industry practice" at the present time. See S. REP. NO. 184, 91st Cong., 1st Sess. 6 (1969). It is interesting to ponder the fate of Dreyfus Corporation, one of the largest advisers in the mutual fund field, which has a flat 0.5% rate and thus far has not instituted a scale-down. See note 59 *supra*. Perhaps Dreyfus Corporation has breached its fiduciary duty to the Dreyfus Fund under the new standard.

An earlier version of the recently enacted legislation¹³⁸ actually included a listing of determinants of the "reasonableness" of advisory fees. Although these factors were subsequently deleted from the bill and the new standard is one of fiduciary duty rather than reasonableness, this listing sheds some light on legislative intent in the absence of a more concrete source of guidance:¹³⁹

- (A) The nature and extent of the services to be provided . . . ;
- (B) The quality of the services theretofore rendered . . . ;
- (C) The extent to which the compensation . . . takes into account economies attributable to the growth and size of such investment company . . . , giving due consideration to the extent to which such economies are reflected in the charges made . . . for investment advisory services . . . to investment companies having no investment adviser [*i.e.*, internally managed], other clients of investment advisers and other financial institutions, but with due allowance for any relevant differences in the nature and extent of the services provided;
- (D) The value of all benefits, in addition to compensation provided for in such contract, directly or indirectly received or receivable by the person undertaking to serve . . . as investment adviser by reason of his relationship to such investment company;
- (E) Such other factors as are appropriate and material.¹⁴⁰

Not only do these factors closely resemble those suggested by the Senate Banking Committee, but they also closely parallel the determinants of fairness set forth in the SEC Report.¹⁴¹ Considering the similarity among all these sources, they cannot be lightly rejected as relevant only to reasonableness and not to fairness.

In view of these sources and what they indicate about legislative intent, it can be argued that a showing of one of the following facts by plaintiffs will shift the burden of explanation (and possibly of persuasion) to the defendant: (I) the services provided to the fund are

¹³⁸ S. 1659, 90th Cong., 1st Sess. § 8(d) (1967). See note 76 *supra*.

¹³⁹ One writer has stated that the removal by Congress of this listing was an effort to avoid binding the courts to any specific test of reasonableness, rather than an expression that these factors were irrelevant to reasonableness. Rottenberg, *supra* note 22, at 335 & n.122.

¹⁴⁰ Investment Company Act, proposed § 15(d)(2), S. 1659, 90th Cong., 1st Sess. § 8(d) (1967).

¹⁴¹ See notes 71-74 and accompanying text *supra*, for the SEC Report's recommended determinants of reasonableness. See also text accompanying note 76 *supra*. Considering the SEC's statement that the fiduciary standard is an "even more effective method than its original proposal to test the reasonableness of mutual fund management fees," it is certainly arguable that these factors are equally relevant to either reasonableness or fairness (fairness being the test of breaches of fiduciary duty). See note 84 *supra*.

considerably fewer than those provided at a similar price for similar size funds by their advisers; (2) the performance of a fund has been substantially poorer than other similar sized funds, yet it continues to pay the same or higher fees; (3) other funds of comparable size pay significantly lower fees; (4) considering the total level of compensation of the adviser, the adviser's profits are in excess of profits received by comparable fund advisers; (5) the adviser charges non-fund clients substantially lower rates; (6) other financial institutions charge considerably lower rates for similar investor services; or (7) the rates have remained essentially constant over the years, while the fund's net assets have increased substantially.

Possible defenses to the various kinds of prima facie cases of unfairness that might be made out by plaintiffs, although not discussed by Congress or the SEC, can be readily formulated. For example, cost justification would seem to be an important defense in most cases. If the adviser can show that his fund of necessity experiences a higher cost ratio than comparable funds, or that another adviser charging lower fees has been losing money, then his higher fees might be justified. The performance of additional services or above-average performance might likewise justify higher fees.¹⁴²

CONCLUSION

The new mutual fund legislation, as it applies to management fees, reflects an effort by Congress to alter the tests courts must apply in suits brought by shareholders challenging the levels of management compensation. Fiduciary principles can be applied to make shareholder suits under section 36(b) an effective means of lowering management fees. If years of legislative wrangling had any purpose, it is that the shareholder must have an easier burden when he seeks to establish the unfairness of advisory fees. Courts should interpret the new fiduciary standard to widen their scope of inquiry as far as possible—beyond shareholder ratification and the generally accepted industry rate structure, towards a more thorough examination of all relevant factors. The fiduciary standard is sufficiently broad to allow courts to consider and weigh all conflicting interests and arguments, and to determine whether the challenged rates are fair. The legislation should be viewed as a mandate to do so.

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¹⁴² These justifications logically follow from the listing of determinants of fairness, although there are as yet no cases in point.